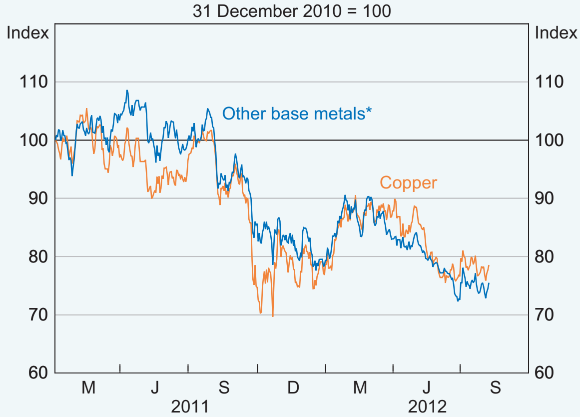
Box C

Recent Developments in the Global Copper Market

The price of copper has declined by 13 per cent since its peak in February this year, broadly in line with declines in the prices of other base metals (Graph C1). These price falls occurred alongside expectations for a slowdown in the global economy, including in China.

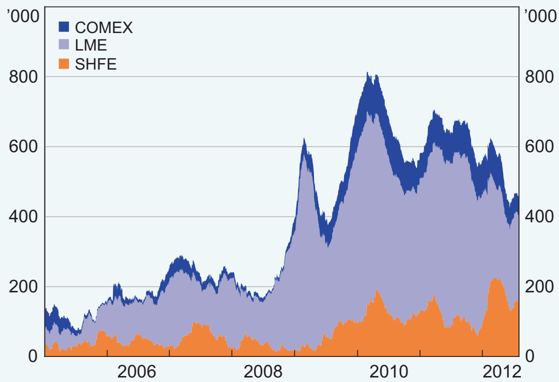
Graph C1
Base Metals Prices
31 December 2010 = 100



* Aluminium, lead, nickel and zinc weighted by global consumption
Sources: Bloomberg; RBA

On the face of it, the recent decline in the price of copper appears to be at odds with a sharp decline in the level of copper inventories held in London Metal Exchange (LME) warehouses from late last year, since the latter would seem to suggest that conditions in the global copper market remain relatively tight (Graph C2). Changes in LME inventories are usually interpreted as indicative of global developments, as the LME captures the largest share of global financial market trading of copper, and futures traded at the LME are widely accepted as the global benchmark. Furthermore, copper inventories that are deliverable under LME futures contracts are held in LME warehouses around the world.

Graph C2
Exchange-held Copper Inventories
Tonnes



Sources: Bloomberg; RBA

The explanation for this apparent discrepancy between declining copper prices and declining LME inventories to some extent lies in recognising the growing role of China in commodity markets. In particular, copper inventories at Shanghai Futures Exchange (SHFE) warehouses have increased significantly over recent years, to around 160 000 tonnes. Once these inventories are taken into account, the decline in global exchange-held inventories is not so marked.[1] Moreover, analysts' estimates suggest that non-SHFE warehouses in China hold an additional 550 000 to 1 million tonnes of copper, indicating that exchange-held inventories are still only a partial measure of global copper inventories.

Anecdotal evidence suggests that some of the increase in Chinese copper inventories has been related to the use of inventory financing schemes, though reports indicate that collateral for these

1 In addition to the LME and the SHFE, the COMEX commodities exchange is a third major copper exchange, based in the United States. COMEX warehouses currently hold around 53 000 tonnes of copper.

schemes is not limited to copper. While firms that hold copper inventories (such as copper smelters and construction firms) might seek to borrow against these inventories as a normal part of their business, some firms in China have taken advantage of this source of finance by accumulating additional copper inventories for use in schemes designed to circumvent credit restrictions, particularly on investment in the Chinese property market during the recent boom. Under these inventory financing schemes, firms purchase copper on deferred payment terms (and on an unsecured basis) to use as collateral for obtaining renminbi-denominated loans from Chinese banks, with the proceeds of these loans either invested directly or on-lent in the unsupervised lending market. When copper prices were rising, firms taking advantage of these schemes could earn a return from holding copper in addition to the return on the investment that was financed by the loan.

The Chinese Government has sought to restrict the use of inventory financing schemes for speculative investment since at least the middle of last year. Demand for these schemes has also fallen for a number of other reasons including, most particularly, weaker conditions in the Chinese property market which have dampened the attractiveness of speculative property investment. Returns on holding copper have also declined alongside the recent fall in copper prices. Moreover, the slope of the copper futures curve has become less positive at the short end – with the three-month futures price even falling below the spot price during the June quarter – suggesting that firms buying copper to use as collateral are less likely to earn a return when the copper is sold.

These developments suggest that copper inventories held only by LME warehouses can no longer be regarded as a reliable global indicator. Instead, the recent accumulation of Chinese copper inventories – and the potential now for a rundown as inventory financing schemes have become less attractive – underscores the importance of understanding Chinese developments and their implications for supply and demand in the global copper market.